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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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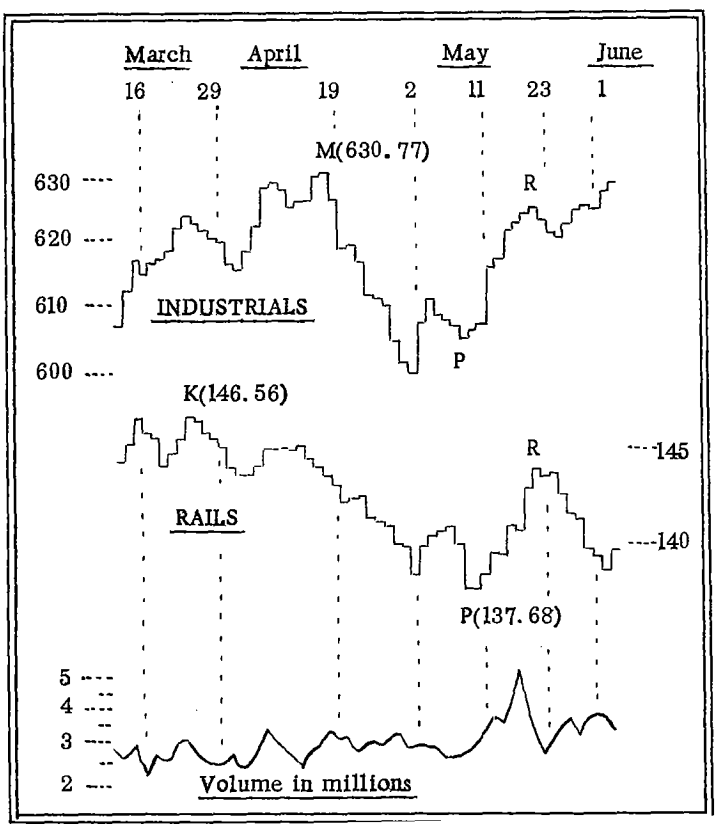
PRICE MOVEMENTS. This mailing finds Industrials within striking distance (above on an intra-day basis) of their secondary high point at M (630.77), while Rails are approximately four points from R and six points from their secondary high point at K (146.56). An Industrial bettering of M with Rails persistently refusing to advance first above point R (143.91) and then above K would be a potentially dangerous structure. Volume over the last fourteen days has averaged 3.58 million shares per day, which is high. A great deal of fuel has been expended (so far) without the two Averages bettering the secondary highs.

MARKET. Fortunately, the study of the price movement is not an exact science nor will it ever be. As Rhea often pointed out -- the end of stock speculation will come when someone using Dow's Theory or some other theory discovers a workable method of "beating" the market. As of this writing, no perfect market system has been developed, and thus we have only past case histories of the price movements to guide us in our present-day studies.

In the last Letter I commented on the spectacular divergence (the Averages moving in opposite directions) which appeared during October-November, 1959. Normally the two Averages travel together as if "locked in gear"; they have done so throughout the 64 year history of the D-J Averages. When the two indicators take separate paths the implications are that the nation's shipping and production are out-of-gear and that there will either be a forthcoming expansion in one or a contraction in the other.

From mid-March to mid-April, 1960 (see chart) another series of divergent movements occurred as Industrials worked higher and Rails dropped away. The two Averages finally got in gear on the downside, and the bear market lows were tested in mid-May. Rails thereupon recorded a new low at P (137.68), but Industrials refused to confirm. This set off another rally. Beginning May 24 Rails again fell away while Industrials marched in the opposite direction. As has been apparent since July, 1959, the action of Rails (shipping) continues to belie the more optimistic action of Industrials (manufacturing).



APPRAISAL. The following is from John Kenneth Galbraith's book, "The Great Crash". Galbraith notes that in 1929 Andrew W. Mellon, the Secretary of the Treasury, announced, "There is no cause for worry. The high tide of prosperity will continue." Galbraith goes on, "Mr. Mellon did not know. Neither did any of the other public figures who then, as since, made similar statements. These are

not forecasts; it is not to be supposed that the men who make them are priviledged to look farther into the future that the rest. Mr. Mellon was participating in a ritual which, in our society, is thought to be of great value for influencing the course of the business cycle. By affirming solemnly that prosperity will continue, it is believed that one can help insure that prosperity will in fact continue. Especially among businessmen the faith in the efficiency of such incantation is very great."

The above is not an attempt to equate the conditions then with circumstances now. Neither Dow's Theory nor any other theory can predict the extent or duration of a bear market decline or business depression. What I do want to convey is that "talk" has never stemmed the tide -- it never will. Steel production is now nearing the levels of the last recession, but we are told that this is all temporary and that the steel operating rate will bottom out in July or August. We are told that auto and retail sales are to have a late spring surge. Inventory building will pick up in the fall. Over-capacity in oil and copper will be corrected in the next year or so. Residential housing will shortly turn up with the advant of better weather and easier money. All of these predictions may indeed materialize, but optimistic forecasts and soothing words will not make them do so. The value of Dow's Theory is that it listens to the "money", not the "talk". The pattern of the Averages, wrote Hamilton, is the sum total of everything anybody knows "sifted down to the bloodless verdict of the market place."

In my opinion, the market is now appraising the possibilities of the third and fourth quarters of 1960. If the two Averages can hold above the bear market lows (Rails 137.68, Industrials 599.10), or if they succeed in bettering their secondary highs (Rails 146.56, Industrials 630.77) the verdict will be for at least a temporary pick-up in the fall. If,on the other hand, the Averages jointly penetrate their bear market lows, they will be sayin that there is not going to be a fall upturn. They will be predicting further production cutbacks, lower sales and increasing unemployment. If such is the case all the talk in the world will not change the facts. For the market itself considers all the talk, all the statistics, all the facts and all the hopes before rendering its verdict.

1929 AND NOW I continue to receive correspondence from people who insist that the bull market could not have "topped" since, in their opinion, the third phase speculation during 1958-59 did not match that of 1928-29. It is unfortunate that 1929 and its aftermath are held up as the single criterion for every primary turn. I have often harbored the suspicion that the recent bull market might top in a manner different from 1929.

Between September 3, 1929 and November 13, 1929, the D-J Industrials "crashed" from 381 to 198. Margins in 1929 were 10%; in 1959-60 they were 90%. Brokers' loans in September, 1929 hit 8.5 billion, while in July, 1959 they were 2.7 billion. Obviously, the stock market was on a relative cash basis in 1959; in 1929 it was pyramided on "a shoestring". For this reason, when prices broke in '29 the "cradle came down" in one fell swoop, while in 1960 (so far) prices have merely eroded.

When I talk about "prices" I am referring to prices as measured by the Dow Stocks. The Dow Theory is based on stocks that represent the "backbone" of the economy, and this idea may be confusing to some people. "How can this be a bear market," optimists demand, "when Texas Instruments is sky-rocketing?" A friend from White Weld & Co. came up with the following tell-tale figures:

1959 sales of General Motors (a Dow stock).....11.2 billion dollars.
1959 sales of Transitron... 31 million; Polaroid....90 million; Texas Instruments...193 million; Litton....126 million; Varian....38 million. Total sales of the five listed "glamour stocks"....478 million. To eliminate debate let us add 25% to the sales of the

five glamour stocks equal a little more than three weeks of General Motors' sales!

Conclusion -- when we talk about the market and the trend of the economy we are talking about the type of stocks that make up the D-J Averages, not Paramount Pictures in 1930, Kaiser Motors in 1946 or Texas Instruments in 1960.

To get back to the main topic, it is possible that the exact circumstances of 1929 will never again be repeated. For the sake of argument, however, suppose that they had. Suppose that prices had broken in January, 1960, from 685 to 350. Is there a stockholder in the nation who would not have shouted, "It's 1929 all over again, I'm selling out!" In other words, if a crash anything like '29 had re-occurred, people would have been only too ready to believe that the bull market had ended. Remember that in 1929 there was no precedent for the "Great Crash", but we today have that precedent. Since the turn almost always comes without the great majority knowing it, I have wondered if "something new" might not be in the cards for the great bull market of the '50's.

That something new seems to be a gradual attrition, group by group, with "cover-up" groups such as electronics and business machines making the picture appear brighter than it is. Of course there is nothing really "new" in this. For instance, a great bull market topped in January, 1906 although business statistics and many stocks were higher at the end of the year than at the beginning. Things did not really get nasty until the "Panic of 1907" (17 months after the bear signal).

But those who claim that the recent bull market's third phase speculation did not compare to 1929 will get no agreement from me. In 1929 with a population of 120 million there were 1.5 million listed brokerage accounts or about 1.35% of the population. In 1959 with a population of 185 million there were 12.5 million accounts or 8% of the total population. How do these figures compare as to distribution and extent of public participation? In 1929 the D-J Industrials topped at an average yield of 3.1%; in July of 1959 the average yield on the D-J Industrials was 2.92%. The price-earnings ratio on the D-J Industrials in 1929 at the high was 19.12; at the high in 1959 it was 19.88. How does this compare in extent of over-evaluation? In 1929 Standard & Poor's Low-Priced Stock Index hit a high of 47.8; in 1959 that Index touched a peak of 78.6. This suggests, if nothing else, that 1958-59 was the greatest rise in the "cats-and-dogs" in thirty years.

In 1929 the total of all public and private debt was 191 billion, while that total is now 846 billion. True, national income has increased tremendously since the '20's, but debt recedes slowly if at all while national income can contract rapidly during an economic reversal. From 1921 to 1929 the total of all public and private debt increased from 135 billion to 191 billion or 41%. From 1949 to 1959 the total public and private debt increased from 448 billion to 859 billion or 85%. In 1929 every man, woman and child owed a total of $1,590.00; in 1960 every American owes a total of $4,600.00. Which period saw the greater speculation in the economy?

The current cost of debt can be judged from the latest figures issued by the Tax Foundation, which show that one out of every four dollars of income in the U.S. now goes for taxes. In the 1920's income taxes were negligible, and the Federal income tax on a personal income of $8,000.00 or over ran to about 5%. Taxes were so low, in fact, that in 1929 when Hoover lowered the income tax it was argued that the resultant benefits to consumers would not be great enough to have any appreciable effect on the national purchasing power.

During the 1930's and the rise of the Keynesian philosophy, it was held that "pump priming" was economically justifiable. But Keynes also said that during periods of prosperity there should be an effort to reduce the debt that was incurred during the "lean years". The advocates of the Keynesian philosophy (both Democrats and Republicans) have forgotten this little facet of Keynes's theory. Thus debt has piled up in larger amounts during the 1950's than ever before.

All of which comes back to Rhea's comment regarding identification of a bull market's third phase, which was simply "How hot is hot?". I am inclined to believe that 1958 and 1959 have generated enough heat to qualify for a great bull market's third phase.

A DISTRIBUTION The accompanying chart (courtesy of Traders Research, Inc. Rm. 4600, 70 Pine St., N.Y.C.) shows an interesting and typical pattern of distribution in a major oil equity, Atlantic Refining. The actual "top" was such a large affair that it can only be recognized on a weekly chart (left-hand section). On the weekly we see the well-known "head-and-shoulder" distribution pattern, which began in early 1959. The left shoulder is marked 1 on the chart and is accompanied by heavy volume. The taller head (2) shows a definite decrease in volume, which means that despite higher prices, interest in the stock lagged. On the third rally or right shoulder (3) volume remained low, following which the support (neckline) marked by the horizontal line was violated. Thus the main distribution was completed. The entire pattern obviously suggests that informed interests were distributing AFI on the three well-defined rallies from the base at 44.

On the right section of the chart we see daily price movements. The right shoulder (seen here on a daily basis) was violated in September, 1959, when the base (neckline at A) was broken at 44. The stock then dropped to 39 1/2 (B), and this became another support level. Subsequent violent rallies, each terminating at lower levels, formed a bearish descending triangle formation with the triangle's base holding at 39 1/2 (B).

In February, 1960 (at X) the base of the triangle was violated. This meant that the distributing group had passed out as much stock as possible above the 39 1/2 level. The triangle area became saturated, and the base at B was unsupportable. Shorts might have been put out at 43 when the head-and-shoulder neckline was violated; they might have been put out again when the triangle's base was broken at 39. A weak "pull-back" (at Y) occurred in April, and when this low-volume rally fizzled below B shorting was again warranted.

This study is included to show that sharp rallies and upward moves can be extremely deceptive if not viewed as a part of the larger pattern. Often, when a weak stock rallies (perhaps on a brokerage house recommendation or a bit of spot news) the stock may be in a position for shorting rather than buying.

(Written Monday, May 6 - 1 P.M.)